Myth: Stock Investing Is Inherently Aggressive and Risky

Saturday's With Jim

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Dear Friends,

There is a simple, widely applied test to determine whether one is an aggressive, moderate or conservative diversified investor. The greater the fluctuation in your monthly, quarterly or annual account statements, the more "aggressive" you are as an investor. What are the long-term consequences of your choices? Aggressive diversified investors suffer more statement volatility but they have more, often a lot more, money after 30 years of investment than do conservative investors. How can this be? How can an investment strategy which results in greater long-term returns be called aggressive? Shouldn't we call it "smart"?

Diversification Reduces Risk of Total Loss

Let's look at risk at the probability of loss. Going to the track to bet on your exacta hunch will very likely mean that you have a nice day in the sun and some excitement as you track your horses' performance, leaving you with a full load of vitamin D and a wad of torn pari-mutuel tickets. You have had a good time, but lost all or most of your betting principal. Your undiversified investment failed. Could a diversified portfolio of quality company stocks fail equally miserably? That is highly unlikely. If we invest in all of the quality company stocks in the stock market, perhaps 5% of them will disappear due to business failure over a period of 30 years. The other 95% will continue to grow their earnings. Looking at it another way, the S&P 500 Index has turned over 40% of its 500 stock portfolio over the last ten years (no information on failures and at least some of the turnover represents mergers of members) while it gained 7% a year on average. So what's the price for growing with the economy? It's not in the actual probability of real loss, but in the volatility of your periodic statement balances. Long-term studies of stock market returns conclude that common stocks yield a total return (price changes plus dividends) of 8%-11% per year on average. On the way to those long-term returns, though, a diversified investor will experience losses greater than 20% perhaps once every seven years and routine losses of 5% to 10% perhaps once a year. Diversification (holding multiple stocks) eliminates the risk of total, catastrophic loss while also reducing statement volatility.

Adding Nuance

Convention holds that portfolios of more than about 60%-70% common stocks are aggressive. But if stock holdings are restricted to quality companies – those with relatively predictable earnings, increasing dividends, low debt and a competitive advantage over competitors – you will experience roughly 10%-15% lower statement volatility.

It follows that we can safely increase your stock weighting relative to bonds and cash by roughly 11%-17% above the 60/40 norm, upping your overall volatility only slightly. But why would we want more stocks in your portfolio?

Stocks Over Bonds for the Long Term

Stocks gain about twice the returns as bonds over long (secular) periods. Quality stocks have predictable, growing earnings that result in growing cash income through dividends paid to your accounts and stocks with pricing power and competitive advantages (like our quality stocks) match or exceed the rate of inflation. Stocks look much less risky when you consider that stock dividends have risen in 40 of the last 43 years. Considering the advantages of a diversified basket of quality stocks, is it rational to own bonds? If so, in what proportion?

Adjusting Expected Volatility with the Bond-Stock Mix

There are two primary considerations in deciding how to divide your wealth into pockets of different asset types – stocks, bonds, cash, hard assets and currencies:

- How much annual volatility you can handle
- How much return you need to get to your goal

Since stocks (the more volatile asset class) return more than bonds, it follows that if your need is great you will need more stocks and vice versa. When compiling portfolios, we must also consider the amount of emotional angst you can handle when you encounter the occasional 20%+ drop in account value. For some, emotional angst when your statement balance drops significantly might be great enough to overcome your need for a high return – even though we logically know that you will continue to receive dividends even in bad times and that stock prices will eventually recover, to go on to new highs. We can, then, balance your need for investment returns with your tolerance for statement volatility by varying the mix of stocks and less volatile bonds and cash.

Summing Up

The terms aggressive, moderate and conservative are not very useful in forming investment portfolios because they consider only one metric – volatility – and the terms themselves might carry meaning beyond investment. Volatility is ephemeral in diversified portfolios and does not portend total loss. Truly aggressive portfolios are those concentrated in a very small number of small, unproven companies, any number of which can fail completely and lose 100% of our capital. We prefer the term "tempo" to describe the continuum of portfolio volatility and expected return.

Thanks for reading today. We really enjoy our work with you.